Economic | STRATEGY | Institute

RECEIVED

AUG 30 1996

Federal Communications Commission
Office of Secretary

August 29, 1996

Mr. William F. Caton
Secretary
Federal Communications Commission
Room 222
1919 M St., NW
Washington, DC 20554

RE: CC Docket 96-150 -- In the Matter of Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996

Dear Mr. Caton:

Enclosed for filing with the Commission are an original and four copies of the comments of the Economic Strategy Institute regarding the above proceeding. If you could kindly acknowledge receipt of this document by date stamping the extra copy and returning it in the enclosed self-addressed envelope, it would be much appreciated.

Respectfully submitted,

Dr. Lawrence Chimerine
Chief Economist

Enclosures

E | S | I

1401 H Street NW Suite 750 | Washington, D.C. 20005 | 202.289.1288 fax 202.289.1319

RECEIVED

AUG 30 1996

Federal Communications Commission
Office of Secretary

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Implementation of the Telecommunications Act of 1996:	)	CC Docket No. 96-150
Accounting Safeguards Under the Telecommunications Act of 1996	)	

DOCKET FILE COPY ORIGINAL

REPLY COMMENTS OF THE ECONOMIC STRATEGY INSTITUTE

Robert Cohen
Economic Strategy Institute
Visiting Fellow
1401 H St., NW Suite 750
Washington, DC 20005

Erik R. Olbeter
Economic Strategy Institute
Visiting Fellow
1401 H St., NW Suite 750
Washington, DC 20005

August 30, 1996

In CC Docket No. 96-150 ("Docket"), the Commission has asked for comments on the ability of a vertically integrated firm with monopoly power in one market to exercise market power in another competitive market. This issue is critical to developing a pro-competitive regulatory environment, one which delivers lower prices and higher quality service to consumers. In fact, as competition develops, it will affect more than national and international telecommunications markets.

The primary danger that arises from this relationship is the price squeeze. The International Bureau has been reluctant to accept the validity of an argument that gives priority to the "price squeeze" approach. In these Reply Comments, the Economic Strategy Institute ("Institute") recommends that the FCC begin adopting rules to ensure that vertically integrated firms with proven market power be more strictly regulated than firms without the potential to price squeeze.

The Institute's submission for this Docket argues that there are clear historical precedents in the industrial organization literature that suggest that a price squeeze analysis should be given credence. There is, in fact, a large volume of anti-trust and economic literature supporting the need for regulatory intervention in cases of price squeezing in both national and international markets. The extensive literature in the field of industrial organization identifies a number of cases that have been explored in detail. These examples corroborate the existence of price squeezes in domestic industries and enumerate their detrimental impact on competition and prices.[1]

The Institute believes that when the broader international delivery of communications services is analyzed, the possibility of price squeeze in the communications sector should be viewed as real. Our evidence for this is summarized in part in this document and will be explained in greater detail in several forthcoming publications. In essence, when the international structure of communications service firms permits them to create transfers that mirror the price squeeze behavior that is well documented in the domestic market, the Institute will argue that the FCC should begin to take steps to prevent this type of monopolistic practice from causing harm to the U.S. communications industry.[2]

The recent changes in the regulatory framework for the local exchange area set up the potential for a price squeeze to occur if existing service providers or powerful foreign entities become important providers of communications. The new environment should not be expected to be free of this type of dominance. Nor should the FCC overlook the possibility that foreign carriers exert an unfair advantage in the local area, even if such carriers have played only a limited role in the U.S.

---

[1] *See, e.g.,* Walter Adams and Joel Dirlam, American Economic Review, Volume 54, September 1964. This pioneering work explored the implications of the price squeeze in the steel industry, particularly in the production of wire rods sold to wire fabricators and processors.

[2] The theory and examples given in these Reply Comments will be followed be more detailed analysis and recapitulation of the events and consequences of the price squeeze.

communications industry until now.

Rather, the FCC should begin to examine what potential exists for anti-competitive practices in the local area. The Economic Strategy Institute believes that one such practice could be the use of international settlements to act as a way to "transfer price" within various entities of international communications firms, with such transfers providing affiliates in the local area with unfair advantages over other entities. The Institute is quite familiar with such transfer pricing in other instances abroad. While this practice has often been linked to multinational firms operating in developing nations, there is no reason to expect that it could not be used in the U.S. domestic market.

Vertically Integrated Firms and the Price Squeeze

Of particular concern in this matter is whether BOC affiliates should be classified as dominant in the in-region, interstate domestic inter-LATA, in-region, interstate, domestic, interexchange services, and international interexchange market. The determination to whether firms should be placed under greater regulatory scrutiny rests upon their ability to exercise market power, i.e. whether firms can raise and sustain prices by restricting their own output, or to raise and sustain prices by increasing their rivals' costs, or by restricting their rivals' output through control of essential facilities.

As is the case with all vertically integrated firms that control essential facilities, the BOCs have the opportunity and incentive to price squeeze by passing costs from competitive to bottleneck markets. It is also possible for the vertically integrated firm to discriminate in quality of service and reduce the quality of services offered by its competitors. This practice may lead to higher costs and lower quality for consumers in the short and long-term.

While the Telecommunications Act of 1996 and technological developments will undoubtedly change the nature of competition in the local exchange – and already have in many respects – this process is not rapid, nor does it impact all markets of the local loop. Many studies and analyses have predicted and still maintain that while the local loop is no longer a natural monopoly, LECs have and will continue to hold a monopoly over access services to the local loop, despite this technological progress.[3] Even with a rapid roll-out of technologies that bypass LEC facilities and connect directly with customers, these services will not supply the capacity or substitutability necessary for a truly competitive market.[4]

Monopoly control over bottleneck facilities, if unregulated, can and will lead directly to the increase in rival costs and higher prices for these services. In the presence of price cap regulation on a monopoly market, companies shift to imputation as the way to increase revenue and gain leverage in the market. The bottleneck controller can impose extra costs through the interface with the bottleneck, and raise the price of its competitors in the downstream activity. By raising the price of inputs of its competitors or decreasing the quality of service (an equally plausible alternative), its affiliate will enjoy either higher profit margins or higher quality service, and will attract a greater number of customers. The numerous links between long distance and local exchange networks means that joint costs are higher than many would expect. By doing so, the regulated activity charges above-cost based rates to all firms in the competitive marketplace, including its own affiliate, and the latter is left with a cost structure that is less than that of its rivals.

In theory, a perfectly executed cost accounting methodology, allocating cost to the appropriate service, would erase this problem. The pursuit of a cost-based charge is noble but will always be futile. Data is not kept in forms that allow this to happen. Cost accounting methodologies and models leave room for manipulation and interpretation. Methodologies and models abound producing figures with ranges as much as a penny per minute – it is never clear which is closer to costs.[5] Despite the best efforts of a regulatory authority, accounting safeguards alone will fail to protect the marketplace from the abuses of vertically integrated firms.

---

[3] *See, e.g.,* Chimerine, Cohen, Olbeter, *Eliminating Monopolies and Barriers: How to Make the US Telecommunications Industry Truly Competitive*, (Washington: Economic Strategy Institute), June 1995.

[4] *See, e.g.,* William J Baumol and Gregory Sidak, *The Pricing of Inputs Sold to Competitors,* 11 Yale Journal on Regulation, 171 (1994). While asserting that technology and regulatory liberalization would break the local loop monopoly, the authors concluded that, despite this, access services would remain a naturalistic monopoly. *Also see, e.g.,* Lawrence A Sullivan, *Elusive Goals Under the Telecommunications Act: Preserving Long Distance Competition Upon Baby Bell Entry and Attaining Local Exchange Competition: We'll Not Preserve the One Unless We Attain the Other,* 25 Southwestern University Law Review, (1996).

[5] Two highly respected economic consultancies recently employed long run average incremental cost accounting to find the true cost of local loop access in Mexico. The difference in the two figures was $0.61 cents per minute.

Vertically integrated companies have intrinsic incentives to use the power held in one market to maximize overall revenue. The shifting of costs, even on the order of $0.01 per minute, can lead to substantial cost advantages and a price squeeze effect that can drive other competitors out of the market. The imperfections of cost accounting leave ample room to try to transfer common costs, and it would be irresponsible not to adopt a cost accounting methodology that did not benefit them – their competitors certainly will advocate such methodologies. In the end, the vertical monopoly has all of the cards at the negotiating table – they control the essential facilities the other operator needs to compete.

A further incentive stems from the difficulty of actually imposing regulations that deny opportunities for anti-competitive behavior. There will always be gray areas in regulations and these areas will be exploited by vertically integrated firms to thwart competitors.[6] As regulations become more precise, firms become more savvy. The Commission has heard time and time again of "minor infractions," for example, in the AT&T - NYT case, stories of colocation cages taking 9 to 13 months to build, and problems MCI has faced in getting unbundled loop components (the RBOC in this case changed the wrong components). Kick-codes and T-caps also have exemplified the incentives for the BOCs to raise the price of their competitors even before they have entered the market – now that they are entering the market, the incentives will be heightened by an order of magnitude.[7]

Interconnection requires cooperation. However, cooperation among firms in a competitive market is not a natural relationship. Interconnection between a vertically integrated firm and its competitor in an affiliated market is an unholy matrimony – a shotgun wedding where the monopoly is unwilling and the regulator is holding the legal and punitive carrot and stick. The vertical monopoly may have no choice but to interconnect. However, if it can transfer market power or stymie its adversaries, it will.

---

[6] *See, e.g.*, Nina W. Cornell, Speech given at Federal Communications Commission, Economic Forum: Antitrust and Economic Issues, July 23, 1996.
[7] *See, e.g.*, Nina W. Cornell, Speech given at Federal Communications Commission, Economic Forum: Antitrust and Economic Issues, July 23, 1996.

Telcel now controls approximately 57 percent of the market nationwide. In the end, this practice of price squeezing is costing Mexico jobs, as Band A firms attempt to reduce their costs, may lead to further consolidation within the industry, and is proving a major deterrent to once enthusiastic PCS entrants. It could also lead to an explosion in prices – in an effort to return to normal profit margins, the Band A providers may well match any increase that Telcel initiates.

International Services

The price squeeze problem faced by firms in the inter-LATA, domestic market, will soon be seen in the international market. Foreign monopolies maintain the ability to raise the price of inputs for US firms via the accounting rate mechanism. As foreign firms with monopoly power overseas enter the U.S. market, the problem of the price squeeze becomes more acute and U.S. firms will be placed at a competitive disadvantage vis a vis their foreign rivals.[10] For example, assume that Telefonica de España creates a separate affiliate to provide inter-LATA domestic and international services in the United States. This affiliate receives an infusion of cash from Telefonica and competes with other long distance providers on the U.S-Spain route. Telefonica could use its monopoly power to maintain or raise already above-cost accounting rates (i.e. include some of the costs of its U.S. affiliate in the charge), and then underprice competitors along all service routes.[11]

If the market for foreign international facilities-based communications is competitive (and assuming no capacity restraints exist), then foreign firms cannot raise prices without losing business and hence no price squeeze occurs. However, there are very few countries where facilities-based competition exists, and it is not likely to be widespread anytime in the near future.

This very plausible scenario is identical to the intra-LATA and inter-LATA scenarios the Commission is now considering. Just as the FCC is taking proactive measures to avert the possibility of cross-subsidization and price squeezing, it should review the potential for price squeezes from foreign firms entering the U.S. market.

[10] This hypothetical assumes that the United States abandons the ECO test provisions on foreign entry into the United States. This policy change is being advocated by many WTO members involved in the Negotiating Group on Basic Telecommunications, now underway.

[11] Telefonica could replicate this pattern on other routes where it maintains a monopoly in the foreign country, e.g. Argentina, etc..

Other Industries

The Commission correctly notes in its Notice of Proposed Rulemaking that price squeezes have been found to exist in other industries. In *United States v Aluminum Co. of America*[8] (Alcoa), the Second Circuit acknowledged that the price squeeze was an abuse of monopoly power and harmful to the industry. Alcoa maintained a monopoly in the upstream market (aluminum ingot) and also operated in the competitive downstream market for aluminum sheets. Alcoa's sheet prices in many instances were lower than the cost of aluminum ingot plus the cost of transforming the ingots into sheets. The court held that this action was anti-competitive because it satisfied four criteria: Alcoa had market power in downstream market; Alcoa's prices in the downstream market were "higher than a 'fair price'"[9]; the product produced in the monopoly market was indeed an input to the second market; and lastly, the price Alcoa charged in the downstream market precluded competitors to earn a "living profit." This case and other examples of the price squeeze from the steel, computer, and electric utility industries will be highlighted in an upcoming ESI study.

International Experiences

A clear example of the impact of the price squeeze is evident in Mexico, where Telmex maintains a vertical monopoly in the long distance, access and local exchange market. It also operates a nationwide cellular company competing in duopoly markets. With access charges fixed at 5 US cents/minute for cellular firms – far exceeding the US price and the highest in the world when measured at purchasing power parity – Telmex has been able to practice both price squeezes and maintain high prices at the expense of the Band A firms.

Starting in 1990, Telcel (Telmex's cellular subsidiary) maintained prices at about the same level as its competitors and market share was approximately 55 percent Band A firms and 45 percent Telcel. Starting around 1994, Telcel began reducing the price of its services through phone giveaways, cheaper roaming charges, and even lower basic rates. (A recent case brought before Mexico's anti-trust authority by Telcel's largest competitors, Iusacell, charges and effectively proves, that Telcel is pricing below cost.) The result: a radical shift in both market share and profits, as well as consolidation within the industry.

---

[8] 148 F.2d 416, 437-38 (2nd Cir. 1945).

[9] The 'fair price' test has been widely criticized for being difficult to define. Several other tests based on rate of return, transfer prices, and billing have been applied in similar cases.

Telcel now controls approximately 57 percent of the market nationwide. In the end, this practice of price squeezing is costing Mexico jobs, as Band A firms attempt to reduce their costs, may lead to further consolidation within the industry, and is proving a major deterrent to once enthusiastic PCS entrants. It could also lead to an explosion in prices – in an effort to return to normal profit margins, the Band A providers may well match any increase that Telcel initiates.

International Services

The price squeeze problem faced by firms in the inter-LATA, domestic market, will soon be seen in the international market. Foreign monopolies maintain the ability to raise the price of inputs for US firms via the accounting rate mechanism. As foreign firms with monopoly power overseas enter the U.S. market, the problem of the price squeeze becomes more acute and U.S. firms will be placed at a competitive disadvantage vis a vis their foreign rivals.[10] For example, assume that Telefonica de España creates a separate affiliate to provide inter-LATA domestic and international services in the United States. This affiliate receives an infusion of cash from Telefonica and competes with other long distance providers on the U.S-Spain route. Telefonica could use its monopoly power to maintain or raise already above-cost accounting rates (i.e. include some of the costs of its U.S. affiliate in the charge), and then underprice competitors along all service routes.[11]

If the market for foreign international facilities-based communications is competitive (and assuming no capacity restraints exist), then foreign firms cannot raise prices without losing business and hence no price squeeze occurs. However, there are very few countries where facilities-based competition exists, and it is not likely to be widespread anytime in the near future.

This very plausible scenario is identical to the intra-LATA and inter-LATA scenarios the Commission is now considering. Just as the FCC is taking proactive measures to avert the possibility of cross-subsidization and price squeezing, it should review the potential for price squeezes from foreign firms entering the U.S. market.

---

[10] This hypothetical assumes that the United States abandons the ECO test provisions on foreign entry into the United States. This policy change is being advocated by many WTO members involved in the Negotiating Group on Basic Telecommunications, now underway.

[11] Telefonica could replicate this pattern on other routes where it maintains a monopoly in the foreign country, e.g. Argentina, etc..

Conclusions

The most likely scenario is as follows: because of the vagueness of cost accounting and the complexity of the cost components of the networks, the vertically integrated firms will shift costs from the competitive intra-LATA and inter-LATA markets to the access and local exchange markets, thereby lowering the costs of their affiliates and raising the costs of their competitors. This process will likely exist as long as cost accounting remains vague or facilities-based competition evolves in the once monopoly market, whichever comes first. In the meantime this will exist.

The problems of the price squeeze that the commission notes are also serious enough to warrant attention and dominant carrier status for BOC affiliates.[12] While cross-subsidization may be prevented, in theory, by accounting separation, the excess costs that are bundled into the interconnection charge will in essence be a cross-subsidization of the BOC affiliate on an on-going basis. Much has been made of the incentives to the BOCs – whether they will lower or raise prices through this process. It could easily maintain prices 1 or 2 cents below its competitors and gain a significant market share, and maintain this price difference until it reached its own marginal cost which competitors could not match. In reality, the only way to realize cost-based inputs is through a competitive facilities-based market. Until that exists, careful regulations are necessary.

The Economic Strategy Institute is planning a series of papers exploring the potential and implications of a price squeeze by foreign firms and how the FCC should address the accounting rate mechanism in this new environment.

[12] In fact, there have been several recent instances where a BOC has been found to be price squeezing or proposing tariff structures that would allow them to price squeeze. *See, i.e.,* Northwest Payphone Association et al. v. US West Communications, Inc., Docket No. UT-920174, March 17, 1995. The Washington Utility and Transportation Commission found that US West was practicing price squeeze in the payphone market. The UTC ordered US West to reduce its phone access line and answer supervision line side in order to allow firms to give competitors a fair chance in the market.